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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1937

No. 189

BENJAMIN B. FOSTER AND ROBERT R. TODD, EXECUTORS OF THE ESTATE OF ANNA FOSTER FORD, DECEASED,
Petitioner,

vs.

THE UNITED STATES.

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS AND BRIEF IN SUPPORT THEREOF.

HUGH C. BICKFORD,
R. KEMP SLAUGHTER,
C. CLIFTON OWENS,
Counsel for Petitioner.

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THE UNITED STATES.

PETITION FOR WRIT OF CERTIORARI.

This petition seeks writ of certiorari to the United States Court of Claims to review judgment in Benjamin B. Foster and Robert R. Todd, Executors of the Estate of Anna Foster Ford, deceased, *vs.* The United States of America, No. 42642. Original opinion was reported at 17 Fed. Supp. 191; (R. 11) supplemental opinion on motion for new trial was reported at 18 Fed. Supp. 790, (R. 15). On April 5, 1937, motion for new trial was overruled (R. 19).

Question Presented.

A corporation, on October 10, 1929, made a distribution of its capital and surplus in the amount of $1,025,000 in liquidation and cancellation of 500 shares ($50,000 par value) of its total outstanding common capital stock of 2,000 shares ($200,000 par value). It charged $50,000 of this distribution to its capital stock account; the balance of $975,000 was charged against surplus.

Did the court below err in holding that the amount of earned surplus ($975,000) distributed in excess of the paid-in capital ($50,000) should be charged entirely against earnings of the corporation accumulated *prior* to March 1, 1913, instead of, in part, against most recently accumulated earnings in the amount of $330,578.98 accrued subsequent to February 28, 1913 (Sec. 115, Rev. Act of 1928).

This question affects the taxable status of a second dividend distribution in the year 1930 (the taxable year here involved), by a determination whether the earnings in the amount of $330,578.98 are available for that second dividend, or were exhausted by the first.

Summary Statement of the Matter Involved.

The special findings of fact (R. 7-11), based on written stipulation, established that the decedent, on February 11, 1930, was the owner of 155 shares of capital stock of the Foster Lumber Company. On such date she received a dividend of $23,250, part of a total distribution of $225,000 (R. 8). Whether this dividend is taxable in whole or only to the extent of part, is dependent on the effect of a prior distribution, October 10, 1929, in partial liquidation of shares of the corporation stock.

Summarizing, the facts are:

On October 10, 1929, the Foster Lumber Company had:	
Capital Stock outstanding at March 1, 1913—2,000 shares at paid-in par value (R. 10) of	$200,000.00
Surplus	
Undistributed earnings accumulated prior to March 1, 1913 (R. 8, 9)	3,725,000.00
Undistributed earnings accumulated *since* March 1, 1913 (R. 11)	330,578.98

On October 10, 1929, Foster Lumber Company distributed $1,025,000 in cancellation and liquidation of 500 shares,

or one-fourth of its capital stock. On its books $50,000 of this amount was charged against Capital Stock Account, the balance of $975,000 was charged against surplus (R. 10). The court below held that the distribution of $975,000 should be applied against the earnings of $3,725,000 accrued to March 1, 1913, that none of the distribution should be charged against most recently accumulated earnings since 1913. Had the Court held that the distribution of $975,000 should have applied to the extent of the most recently accumulated earnings of $330,578.98, these earnings would have been exhausted and accordingly would not be available for subsequent dividend distributions. In that event the earnings available for subsequent dividend distribution on February 11, 1930, would be only the amount accumulated between October 10, 1929, and February 11, 1930, the sum of $82,758.17 (R. 12).

Reasons for Granting Writ.

1. *The decision below is in conflict with and confuses the law established by every other decision rendered under Section 115 of the Revenue Acts after 1928 and Section 201 of prior Acts.*

a. *Board of Tax Appeals.*—The Board has considered Section 115(c) in its reference to the remainder of Section 115, each time consistently holding that a partial liquidation shall be charged in the following precedence:

First. Against the capital account, that is, the capital paid in, to the extent thereof.

Second. Against the most recently accumulated earnings since March 1, 1913, to the extent thereof.

Third. Against earnings accumulated prior to March 1, 1913.

John B. Stewart v. *Commissioner*, 29 B. T. A. 809;
Horrmann v. *Commissioner*, 34 B. T. A. 1178;
Craig, Executor, v. *Commissioner*, Memorandum Opinion, March 15, 1937, not reported (Attached hereto as Appendix B for ready reference).

The court below admits its decision is in direct conflict with these decisions. In fact, the *Craig* case, *supra,* actually involves another stockholder of the Foster Lumber Company who participated in exactly the same dividends paid to decedent and here involved. There is, therefore, presented the unusual situation of a direct conflict in what is essentially the *same case,* between the Board of Tax Appeals and the court below.

b. *The Federal Courts.*—In *Harter* v. *Helvering,* 79 F. (2d) 12 (C. C. A. 2), a corporation retired its preferred stock in 1926. In 1927 a dividend was paid.* The court held that it was immaterial whether the first distribution was an ordinary distribution under paragraph (b) or a liquidation under paragraph (f) of Section 115; it "must be marshalled first against the earnings after February 28, 1913, for it more than exhausted them. What was left was capital or earlier earnings." As the facts were manifestly the same as here, the decision below is in conflict. In *Glenmore Securities Corp. v. Commissioner,* 62 F. (2d) 780 (C. C. A. 2), the taxpayer was a member of a syndicate in which he invested $40,000. In 1925, 1926 and 1927 the taxpayer's proportionate share was (24 B. T. A. 700, for these facts):

1925	$40,864
1926	12,712
1927	5,977

Only the amount earned in *1925* was actually distributed in liquidation of the original investment. The Commissioner held the syndicate a partnership and taxed the petitioner on distributive shares. The Court of Appeals reversed,

* Several non-taxable reorganizations complicate the facts in *Harter* v. *Helvering,* but as they were held to "carry through" without change in nature of capital or surplus, we believe the ultimate facts are as simple as stated.

held the syndicate was not a partnership, and then considered what the taxable status should be:

> "Assuming, as we must, that the syndicate was not a partnership, we are to decide whether nevertheless the taxpayer has shown that it was over-assessed.
>
> "Two possibilities are open; the syndicate may have been an association, *taxable as a corporation;* or it may have been a trust. In the first case the *statute ascribes the first payments upon partial distribution to the latest earnings, until they are exhausted.* Section 201 (b) (c) of the Act of 1924 (26 U. S. C. A. par. 932 (b, c)). The decisions cover such a situation, and would have allowed an assessment of the whole payment as income, provided it did not impair the capital, as it did not. McCaughn *v.* McCahan, 39 Fed. (2d) 3 (C. C. A. 3); Leland *v.* Commissioner, 50 Fed. (2d) 523 (C. C. A. 1); Phelps *v.* Commissioner, 54 Fed. (2d) 289, 292 (C. C. A. 7); Christopher *v.* Burnett, 60 App. D. C. 365, 55 Fed. (2d) 527."

Thus, the Second Circuit holds that the consistent holding of "the decisions" is to ascribe earnings upon partial liquidation to the latest earnings (*i. e.*, those subsequent to 1913) until exhausted.

There is, therefore, direct conflict between the court below, on the one hand, and the Board of Tax Appeals and the Circuit Court of Appeals for the Second Circuit on the other, a conflict which is expressly admitted by the court below as to the decision of the Board in the same case (R. 19).

2. *The decision below is utterly inconsistent with the plain provisions of the Revenue Act.*

The decision below is based upon the syllogistic reasoning that earnings existing at March 1, 1913, were capital and, therefore, that all of the dividend in partial liquidation must be considered as a charge against "capital account"

and none against earnings and profits. This is directly contrary to the language of the statute; Section 115(c), where material, states:

> "In the case of amounts distributed in partial liquidation * * * the *part* of such distribution which is properly chargeable to capital account shall *not* be considered a distribution of earnings or profits within the meaning of sub-section (b) of this Section for the purpose of determining the taxability of subsequent distributions by the corporation."

This sentence does not refer to earnings and profits before March 1, 1913, alone or earnings after such date. It contra-distinguishes capital account from *all* earnings or profits, a common business practice and accounting custom. Manifestly, if only "*part*" of the partial liquidation is to be "capital account", the whole must include some other part consisting of "earnings or profits". After the "*part*" is charged, there must be left *some* "earnings or profits" within the meaning of subdivision (b) or the language of the sections means nothing. The court below, on the contrary, holds that *none* of the distribution is "earnings or profits" within the meaning of subsection (b).

Furthermore, the decision below conflicts directly with the express prohibition of the statute. Subdivision (b) says:

> "The part * * * which is properly chargeable to capital account *shall not* be considered a distribution of earnings or profits "within * * * sub-section (b)."

Subsection (b) refers both to "earnings or profits" *before* 1913 and "earnings or profits" *after* 1913.

If the statute is observed, the amount charged to "capital account" shall *not* be considered a distribution of *earnings or profits* either before or after 1913. The court below holds that the entire surplus of $925,000 distributed constitutes

earnings or profits *before* 1913, which the statute directly says "shall not" be done.

The difficulty of the court below seems to be that it confuses the terms "dividends" and "earnings or profits" used in Section 115, both of which are expressly defined.* Subsection (a) defines "dividends" as being only "earnings or profits accumulated *after* February 28, 1913." Subsection (b) explains "earnings or profits" as including surplus, *both* before *and* after. Subsection (c) provides for the "part" which shall not be either, that is the "capital account". Obviously, where a corporation distributes $50,000 of its capital invested and $925,000 of its surplus, the surplus must be charged against either the earnings *before* or the earnings *after* 1913. Since, therefore, the statute provides (c), that the "*part* chargeable to capital account" shall not be chargeable to *either*, the "part" must mean the capital stock account because the balance has to be charged against earnings or profits to give the section any logical, ordinary meaning.**

Thus, logically construed, the section means that the capital investment distributed, of $50,000 shall be "capital account", shall not be charged to "earnings or profits" but that the surplus distributed shall be so charged according to the precedence established by sub-section (b); that is, the most recently accumulated earnings shall be distributed first.

3. *The decision below throws into confusion the long standing rule that all earnings and profits are income, subject to tax, as distinguished from paid-in capital.*

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* The Court several times uses the term "dividends" when it means "distributions of earnings or profits" (R. 13, 18).

** Cf. *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215, 218; for distinction between capital and earnings and profits. *Eisner* v. *Macomber*, 252 U. S. 189, 209, 210, 211, discusses ordinary accounting usage.

It is significant that the court below referred to no cases in support of its opinion but merely sought to distinguish those in conflict therewith. The court below held that earnings accumulated at March 1, 1913, "constituted for tax purposes the capital of the taxpayer" (R. 13). The court below thus becomes subject to the confusion between capital and exempt earnings referred to in *U. S.* v. *Safety Car Heating and L. Co.*, 297 U. S. 88, 95, 96.

In *Helvering* v. *Canfield*, 291 U. S. 163, this Court said:

> *"When a corporation continued in business after March 1, 1913, the dividends it later declared and paid to its stockholders, whether out of current earnings or from profits accumulated prior to that date, constituted income to the stockholders, and not capital and were taxable as income if the Congress saw fit to impose the tax* (*Lynch* v. *Hornby*, 247 U. S. 339). The provision of the Act of Congress under consideration was a 'concession to the equity of stockholders' with respect to receipts as to which they had no constitutional immunity. There is no question here of the receipt of 'capital'." (Italics supplied.)

Such prior earnings not being capital, but tax-free income, the syllogistic reasoning by which the court below first holds such earnings to be "capital" and, then, for that reason alone, "capital account", necessarily fails.

The court below attempts to distinguish the *Canfield* case by stating that such case arose under Section 201(b) of the Revenue Act of 1921 (a counterpart of 115(b) in the Revenue Act of 1928) and that the 1921 Act contained no provision similar to Section 115(c) of the 1928 Act. But it is clear Congress meant no change in the conclusive presumption inherent in all the distribution sections of the Act, that whenever earnings and profits are to be distributed the earnings *after* March 1, 1913, shall be distributed *first*. Thus, when 201(c), the antecedent of 115(c)), was first

added in the 1924 Act the Senate Finance Committee said of the last sentence of Section 201(c) here involved:

> No similar provision is contained in the existing law, *although the provisions of the bill represent what is probably the correct construction of the existing law and unquestionably what is in accord with business practice.* (68th Congress, 1st Session; Report No. 398, p. 12.)

Accordingly, Congress was not changing the meaning of the tax statute as stated by the court below, but simply making clearer the accepted concept that distinguishes earnings and profits from capital paid in. *Lynch* v. *Hornby*, 247 U. S. 339; *Eisner* v. *Macomber*, 252 U. S. 189, 209, 210; *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215, 218. The decision below sets aside this well accepted rule and throws into confusion the taxable status of dividends which are not an insignificant part of our national income. In 1936 the portion of the national income paid out in dividends amounted to $4,573,000,000 which compares with $5,969,000,000 paid out in 1929 and with $2,213,000,000 paid out in 1933.* With the added effect of the corporate surtax on undistributed profits it may be expected that the national income from dividends will continue to increase. Questions, such as the one here at issue, involving the taxability of dividends therefore become of widespread importance, both to taxpayers and to the Government.

WHEREFORE your petitioner prays that a writ of certiorari be issued out of and under the seal of this Honorable Court direct to the United States Court of Claims, commanding the court to certify and transmit to this Court for review and determination, on a date to be therein named,

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* Survey of Current Business, June, 1937, page 15, prepared in the Division of Economic Research, Bureau of Foreign and Domestic Commerce.

a full and complete transcript of the record and of the proceedings in the case numbered and entitled on its docket No. 42, Benjamin B. Foster and Robert B. Todd, Executors of the Estate of Anna Foster Ford, Deceased, *vs.* The United States, and that said judgment of said United States Court of Claims be reversed by this Honorable Court and that your petitioner have such other and further relief in the premises as to this Honorable Court may seem meet and just, and your petitioner will ever pray.

HUGH C. BICKFORD,
R. KEMP SLAUGHTER,
C. CLIFTON OWENS,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Opinions Below.

The first opinion of the Court of Claims, reported at 17 Fed. Supp. 191, appears at pages 11 to 15 of the transcript. The supplemental opinion, reported at 18 Fed. Supp. 790, appears at pages 15 to 19 of the transcript. The judgment of the court entered December 7, 1936, appears at page 15 of the transcript. Motion for new trial, filed February 5, 1937, was denied, with supplemental opinion, April 5, 1937 (R. 19).

Jurisdiction.

The jurisdiction of this Court is invoked under Sections 180 and 240 of the Judicial Code as amended by the Act of February 13, 1925.

Facts.

On October 10, 1929, the Foster Lumber Company had capital stock outstanding of 2,000 shares having a paid-in par value of $200,000. It also had on hand accumulated surplus (in round figures) of $4,030,000, of which $330,000 had been accumulated since February 28, 1913 and $3,700,000 had accumulated prior to March 1, 1913. On October 10, 1929, the Company distributed $1,025,000 in complete cancellation of one-fourth of its capital stock, 500 shares. On its books $50,000 (the paid-in par value) was charged against capital stock account, the balance of $975,000 was charged against surplus. In the following year, on February 11, 1930, a dividend of $225,000 was declared. Between the two dividend dates further profits of $82,000

accumulated. After reporting in full this distribution, decedent filed claim for refund, claiming that the first distribution was a distribution of capital and surplus and that the portion representing surplus, $975,000 should be charged against earnings and profits in accordance with Sections 115(b) and (c) of the Revenue Act of 1928, so that the most recently accumulated earnings since 1913 ($330,000) were exhausted thereby. Under this contention only $82,000 in earnings since 1913 would be available for the second distribution in 1930 and, therefore, only 83,000/225,000ths of the second distribution would be subject to tax. The claim was denied and suit was timely brought with the court below, which held that the entire surplus distributed in the first distribution ($975,000) should be charged against earnings prior to 1913, leaving all of the earnings subsequent thereto available for the second distribution in 1930.

The Law.

Applicable provisions of the statutes are set out in the Appendix.

Specifications of Error.

Petitioner makes the following assignments of error:

1. The Court of Claims of the United States erred in holding that none of the distribution of $1,025,000 by the Foster Lumber Company on October 10, 1929, should be considered a distribution of earnings or profits within the meaning of Section 115(b) of the Revenue Act of 1928, as required by Section 115(c) of that Act.

2. The Court of Claims of the United States erred in finding and holding that the earnings and profits at October 10, 1929, accumulated since February 28, 1913, in the amount of $330,578.98 were not distributed as a part of the distribution of $1,025,000 made on that date.

3. The Court of Claims of the United States erred in failing to find and hold that only $82,758.17 of earnings and profits accumulated since February 28, 1913, were available and distributed as a part of the distribution of $225,000 on February 11, 1930.

4. The Court of Claims of the United States erred in entering judgment for the defendant.

ARGUMENT.

The plain provisions of Sections 115(b) and (c), when read together, require surplus distributed to be distinguished from capital account and, therefore, charged against earnings or profits first to the extent of the earnings accumulated since February 28, 1913.

A clear picture of the nature of the question presented may best be obtained by considering the effect upon the book accounts of the corporation of the distribution and partial liquidation on October 11, 1929. ((R. 12).

	Accounts as of Oct. 11, 1929, before distribution.	Liquidation of ¼ of capital stock.	Balance remaining after distribution.
Capital stock account	$200,000	$50,000	$150,000
Surplus account	4,030,000	975,000	3,055,000

It is obvious, in a bookkeeping sense, that the $975,000 excess over the capital paid-in was properly charged against surplus, not only because there was no place else to charge it, but because the liquidation actually represented a distribution of one-fourth of the capital paid in and one-fourth of the surplus accumulated. There was no justification for charging against the capital stock account the surplus distributed. To do so would destroy entirely the capital contribution, raising endless questions of corporate law.

Such practice of keeping the capital contributed separate from surplus accretions is customary accounting practice.*

We submit that the Revenue Act has the same concept. It uses the terms "capital account" and "earnings or profits." If part of a distribution is "capital account" it "shall not be considered * * * earnings or profits." (115(c)). There could not be a more exclusive contra-distinction. Conversely, if a part of the distribution is "earnings or profits" it cannot be chargeable to "capital account." The two portions are mutually exclusive of each other. Yet the court below holds that "earnings or profits" accumulated prior to March 1, 1913, are capital account, which is contrary to law because the statute expressly provides that such capital account shall not be considered * * * "earnings or profits", which term includes earnings both before and after 1913. In other words, "earnings or profits" cannot be "capital account."

The basic defect of the decision below is that it fails to recognize the precise distinctions made in Section 115(a) (b) and (c). As stated in the petition, the statute uses three terms; "dividends" (a); "earnings or profits"—

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* Geier & Mautner, Practical Corporation Accounting, 1930 p. 342, gives the historical development:

"From the beginning of bookkeeping, the traditional method has been to keep the capital contributions distinct from the accretions of profit. Thus the proprietor, consistent with business procedure, could draw profits from the business without encroaching upon his capital. With the development of the modern business corporation other elements entered into the situation. What had been a rational bookkeeping arrangement for segregating classes of information for the guidance of the proprietor became a procedure essential to compliance with legal limitations, such as those respecting the payment of dividends."

"The legal restrictions impressed by statutory provisions regulating par value shares upon the dealings with capital contributions of stockholders have emphasized the necessity of very careful accounting methods in order to avoid unwitting legal violations. The importance of establishing correct accounting procedures to provide that the capital fund shall not be impaired has inevitably influenced the corporation accountant's conception of capital as something that must be isolated from its accretions."

(a), (b) and (c); and "capital account"—(c). In (a) the "dividends" are limited to that *part* of "earnings or profits" earned *after* 1913. In (b) it is made clear that the term "earnings or profits" includes earnings both before and after, and is, therefore, synonymous with the corporate terms "surplus" or "undivided profits." This is clear from the Senate Finance Report explaining the revision of 201(b) in the 1924 Act when 115(c) was changed to its present reading:

> "Section 201(b): (1) The first sentence of section 201(b) of the existing law provides that any distribution made by a corporation shall be deemed to be made out of earnings and profits to the extent of the earnings and profits accumulated after February 28, 1913. It contains no similar presumption as to the source of a distribution made after all such earnings and profits have been distributed. *Since distributions out of earnings and profits accumulated prior to March* 1, 1913, *and distributions out of capital are in some instances treated differently, it is material to know the source of a given distribution, even though all earnings and profits accumulated since February* 28, 1913, *have been distributed.* Consequently, in Section 201(b) of the bill *the presumption that every distribution is out of earnings and profits applies to all earnings and profits, whether accumulated prior or subsequent to* March 1, 1913." (Italics supplied.)

Finally, subsection (c), for purposes of liquidation, distinguishes "capital account" from "earnings or profits." The distinction in (c) is not between capital ad the more restricted "dividends" of (a); it is a distinction between capital and the broader term "earnings or profits" of (b), which includes "dividends", as defined, and also earnings prior to March 1, 1913. The court below constantly holds that this distribution is not a "dividend" when that is not the question because subsection (c) does

not refer to "dividends" or to subsection (a) (R. 13, 17). The question distinctly is: what *part* of the distribution is "capital account" and what other part is "earnings or profits," under subsection (b). A recognition of this distinction in the plain words of the statute makes it manifest that $50,000 of the distribution was the part chargeable to capital account and that $975,000 was the part to be considered "earnings or profits within the meaning of subdivision (b)." Being earnings and profits within (b) the part totaling $975,000 must be charged against earnings subsequent to 1913 to the extent thereof according to the plain words of (b). *John B. Stewart,* 29 B. T. A. 809; *Horrmann* v. *Commissioner,* 34 B. T. A. 1178; *Craig, Executor,* v. *Commissioner,* Memorandum Opinion, not reported, but see Appendix B; *Harter* v. *Helvering,* 79 F. (2d) 12 (C. C. A. 2); *Glenmore Securities Co* v. *Commissioner,* 62 F. (2d) 780, (C. C. A. 2).

Consideration of the Opinions Below.

The court below first rendered opinion without reference to any decided cases (R. 11-15). The substance of the opinion is contained in several sentences which we shall consider in order.

The court first states (R. 13):

> "Clearly the distribution was not a dividend, either in the special sense that the word is used in the statute as defined in section 115(a), or in its meaning as generally used, which is somewhat broader. The definition set out in the statute was evidently inserted to make sure that there could be no claim that a distribution made out of profits was not a dividend. The distinction between a dividend and such a distribution as is made in the case before us is quite plain."

As heretofore pointed out, we are not concerned with "dividends" under subdivision (a) because the controlling

subdivision (c) does not refer to (a) but to "earnings and profits" under (b).

The court further adds (R. 13):

> "When the stockholders obtained the March 1, 1913 value of their stock, it was the realization of capital, and was properly chargeable to capital account."

This is entirely foreign to the question at issue. What was properly chargeable to capital account has reference only to the books of the corporation and not to any accounts that may be conceived as having been kept by the individual stockholders. It is not sufficient to say they received "capital". The corporation distributed capital paid in and also earnings and profits. *Helvering* v. *Canfield, supra.*

The court below then states (R. 14):

> "A consideration of the purpose of section 115(c) of the Act of 1928 and the reports made by the committees of the House and Senate when it first became a part of the revenue law supports the view above expressed. As the law originally stood, the plan devised in the case before us could be carried out so that the earnings and profits accumulated since 1913 would be distributed tax free. The general provisions of 115(b), which were in the former act, would have required the distribution to be treated as made out of earnings or profits accumulated after February 28, 1913, and the distribution would be properly chargeable to surplus and paid out of such profits with the result that the distribution made October 10, 1929, absorbed all of the earnings and profits to that date. Obviously this would enable the stockholders to escape taxation although they had received earnings and profits which had accumulated since February 28, 1913."

This misconstrues the Acts prior to the adoption of 115(c). Prior to that time (except under the 1918 Act),

a liquidation was not tax free but was taxed to the stockholders as a "dividend" to the extent of earnings after March 1, 1913. This was found to be almost impossible of administration because thousands of stockholders did not have the figures to compute such portion of their scattered dividends. Congress, therefore, added 115(c) so as to tax such distributions, in the hands of the individuals, as a gain on sale, which permitted a stockholder to compare his own cost with what he received, a much simpler administrative method. Whether tax was paid in either event depended solely on individual circumstances. As the Senate Finance Committee said in reporting Section 201(c) of the Revenue Act of 1924:

> "Treating such a transaction as a sale and within the capital gain provisions is consistent with the entire theory of the Act and, furthermore, is the only method of treating such distributions which can be easily administered." (Report No. 398, supra. p. 12.)

This applies, of course, only to the first sentence of 201(c) (as does the portion of the Committee Report cited by the court below) and deals with the manner of taxing the gain in the hands of the individual. It has nothing to do with the effect on the earnings and profits in the hands of the corporation provided for in the last sentence of subsection (c) which, as heretofore explained, expressly provides for part to be considered capital account and part to be earnings under subdivision (b).

The court below further says (R. 14):

> "Money paid out in making a return of capital is 'properly chargeable to capital account.'. It is true that the reports presented the matter 'from the point of view of the stockholder' but the principle is the same when applied to the corporation."

How can a corporation with thousands of stockholders who bought their stock at different dates and at different

prices know when it makes a distribution in partial liquidation what was "the capital account" of each individual stockholder? What may be capital account from the point of view of the stockholder (his individual cost) is manifestly quite a different thing from what is the capital account of the corporation making the distribution.

The court below again says (R. 15):

> "If the distribution of 1929 was charged to capital account as it should be according to what we have held above, the profits which had accrued since 1913 and then on hand would not be depleted thereby."

What the court below fails to recognize is that in holding that the distribution was not to be charged to earnings after 1913, it necessarily held that all of the surplus distributed *was* charged to the earnings *prior* to 1913. In other words, it holds that this is the part chargeable to capital account (which "shall not" be considered earnings or profits), and then *actually charges it against earnings and profits prior to 1913,* which is directly contrary to the Section 115(c) which says the part thus chargeable "shall not be considered a distribution of earnings or profits." The whole gist of the matter, under the section quoted, is that *if* the surplus *is* earnings and profits it cannot be chargeable to capital account. It is only by giving the term "capital account" this definition that the statute has logical meaning.

The supplemental opinion (R. 15-19) was rendered after motion for new trial was filed pointing out that the court had considered none of the authorities cited. First, such supplemental opinion seeks to distinguish *Helvering* v. *Canfield, supra,* with the statement that the 1921 Act was different from the 1928 Act. It is true that the 1921 Act taxed a liquidation as a dividend in the hands of the stockholder, while the later act taxes it as a sale. However, that change in the taxable status in the hands of the *individual*

can have no effect on the corporate accounts. As the Senate Finance Committee pointed out, the last sentence, which provided for the effect on the corporation, "represents what is probably the correct construction of the existing law and unquestionably what is in accord with business practice." (*Infra.* Cit.) Congress, therefore, intended no change in the priority of the distribution of accumulated profits, but only in the manner of taxing the distribution in the hands of the individual. So far as this case is concerned, which involves only the last sentence of Section 115(c), and not the first part—the 1928 Act had the same meaning as the 1921 Act and *Helvering* v. *Canfield, supra,* is equally applicable.

The court below then says that in *Stewart* v. *Commissioner,* 29 B. T. A. 809, the Board held that the distribution was not a distribution in partial liquidation (R. 17). The Court is apparently confused by the complexity of the issues in the *Stewart* case, as a careful reading thereof will show. When that case came before the Board there was exactly the situation we have here; a first distribution, which both parties admitted was in partial liquidation, then a second distribution which was admitted to be a regular dividend. The question was exactly the same as here; whether the first liquidating distribution exhausted the earnings after 1913. The Commissioner then raised another affirmative issue to the effect that the *second* distribution was *also* in partial liquidation. The Board held that he had not proved this and refused to hold the *second* distribution to be in liquidation. That disposed of the affirmative issue and the Board then proceeded to decide the case on the remaining original issue, which was exactly similar to the facts here (see page 813; B. T. A. Vol. 29). The court below admits disagreement with *Horrmann* v. *Commissioner,* 34 B. T. A. 1178 (R. 17-18).

As to *Harter* v. *Helvering,* 79 F. (2d) 12, the court holds that that case did not involve a partial liquidation. It is

true that the Second Circuit did not expressly refer to 115(c), but a liquidation was inherent in the case as shown by the Board's decision, *30 B. T. A. 572.* The facts there were also complicated by the existence of several subsidiary corporations, which transferred their capital and surplus between each other until it finally was distributed to the ultimate stockholders. The Court carefully eliminated each of these subsidiary transactions under the reorganization sections, holding that the capital and surplus of each carried through, *in status quo,* to the ultimate transaction. Then the ultimate transaction was this: The final corporation first retired its preferred stock, then paid a dividend, and the question was the effect upon earnings and profits of the first, a liquidating distribution. The same ultimate facts exist here. The Second Circuit held that the distribution "must be marshalled first against the earnings after February 8, 1913, for it more than exhausted them. What was left was capital *or* earlier earnings." It will be noted in the italicized word that the Second Circuit did not miss the precise distinction between "capital" and "earnings prior to March 1, 1913," and accordingly reached the proper conclusion.

The court below then refers to *Hellmich* v. *Hellman,* 276 U. S. 233, and quotes a part of that decision which seems to indicate that all earnings distributed in a liquidation are capital. This Court, in *Hellmich* v. *Hellman,* was considering the manner of taxing a distribution in the hands of the distributee. It was not concerned with the source of the distribution, as we are here. In fact, this Court, in *Hellmich* v. *Hellman,* expressly recognized that the liquidation distribution, although taxable as a sale in the hands of the distributee, was actually out of earnings and profits. The Court said (276 U. S. 236):

> "The controlling question is whether the amounts distributed to the stockholders *out of the earnings and*

> *profits accumulated by the corporation since February* 28, 1913, were to be treated as 'dividends' which were exempt from the normal tax; or, under 201 (c) as payments made by the corporation in exchange for its stock, which were taxable as other gains or profits."

Here, there is no question how the two dividends should be taxed in the hands of the stockholders. The first is admitted by both sides to be taxable as a capital gain, the second as an ordinary dividend. The limited question is the source from which the first dividend was paid, which, to the extent of the surplus was manifestly from "earnings or profits within the meaning of subdivision (b)."

The opinion of *Hellmich* v. *Hellman,* also holds that an entire section should be read so as to bring two subdivisions into harmony and to give to each its natural and due effect is important here. As previously pointed out, Section 115(c) prohibits the charging of that part representing "capital account" against "earnings or profits". The court below nevertheless holds the entire distribution to be "chargeable to capital account" and then proceeds *to charge it against earnings or profits prior to March 1, 1913,* which destroys the whole meaning of the section, and eliminates that part of the subdivision which clearly requires that some part of the distribution shall be considered "within the meaning of subdivision (b)". It is only by considering the capital paid in as the "part properly chargeable to capital account" that the section acquires a logical meaning. Then the paid in capital is charged to capital account and earnings and profits are charged within the meaning of subdivision (b).

The court below then finally directly disagrees with the decision of the Board in *Craig, Executor,* v. *Commissioner* (see Appendix B), in which the Board held as we contend in the case of another stockholder of the same corporation,

who received exactly the same distributions of the Foster Lumber Company as here involved.

The decision of the court below is, therefore, contrary to every other decided case.

Conclusion.

It is respectfully submitted, therefore, that the decision of the Court of Claims below was in error and that the conflicting decisions of the Board of Tax Appeals and the Circuit Court of Appeals for the Second Circuit correctly express the law under Section 115(c) of the Revenue Act. The Court of Claims should, therefore, be reversed and it is accordingly submitted that petition for certiorari should be granted.

HUGH C. BICKFORD,
815 15*th St., N. W.*,
Washington, D. C.,
Attorney for Petitioner.

Of Counsel:
R. KEMP SLAUGHTER.
C. CLIFTON OWENS.

APPENDIX A.

Revenue Act of 1928.

SEC. 115. *Distributions by Corporations.*

(a) Definition of dividend.—The term "dividend" when used in this title, (except in section 203 (a)(4) and section 208 (c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) Source of distributions.—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) Distributions in liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112(h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

(d) Other distributions from capital.—If any distribution (not in partial or complete liquidation) made by a corpora-

tion to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not out of earnings or profits, then the amount of such distribution shall be applied against and reduce the basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. The provisions of this subsection shall also apply to distributions from depletion reserves based on the discovery value of mines.

(h) Definition of partial liquidation.—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

APPENDIX B.

UNITED STATES BOARD OF TAX APPEALS.

Docket No. 74679.

W. H. CRAIG, Executor, Estate of Mary Foster Craig, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

E. C. Boye, C. P. A. and Carl D. Matz, Esq., for the petitioner. Carroll Walker, Esq., for the respondent.

MEMORANDUM OPINION.

ARNOLD:

The respondent determined a deficiency against Mary Foster Craig for the year 1930 in the amount of $363.93. The petitioner brings this proceeding for the redetermination of her tax liability. It is alleged that the respondent erred in including in taxable income for the year 1930, the full amount of a dividend of $21,750 received by Mary Foster Craig from the Foster Lumber Company in 1930.

Mary Foster Craig, deceased October 17, 1933, was during the entire calendar year 1930 and until her death a married citizen of the United States of America with residence at 828 West 56th Street, Kansas City, Missouri.

Mary Foster Craig, before March 15, 1931, filed with the Collector of Internal Revenue at Kansas City, Missouri, her separate individual income tax return for the calendar year 1930. She reported therein a net taxable income of $24,597.56, as having been received by her during that calendar year and a tax liability thereon of $481.83, which entire amount she paid to the Collector of Internal Revenue at the time of filing her said income tax return on February 16, 1931.

On November 17, 1933, the Commissioner of Internal Revenue pursuant to section 272 of the Revenue Act of 1928, addressed a letter to the said Mary Foster Craig advising her of a deficiency in her income tax liability of $363.93, for the calendar year 1930, resulting from a net taxable income of $29,292.94, as redetermined by the Commissioner instead of $24,597.56 as reported in her return.

Mary Foster Craig was, on February 11, 1930, the owner of record of 145 shares of a par value of $100 per share of the total of 1,500 shares of the capital stock of the Foster Lumber Company, a Missouri Corporation. She acquired this stock prior to March 1, 1913. The Foster Lumber Company on February 11, 1930, duly made a dividend distribution in cash of 150 per cent of its capital stock payable pro rata on that date to all stockholders of record on that date. Mary Foster Craig received during the calendar year 1930 the amount of $21,750 from the Foster Lumber Company as her part of the aforementioned distribution on the 145 shares of stock owned by her. The entire amount of the said distribution of $21,750 received by her during 1930 has been included in the net taxable income on which the deficiency in tax is predicated as an ordinary dividend.

On or about August 2, 1932, the said Mary Foster Craig filed with the Collector of Internal Revenue at Kansas City, Missouri, a claim for refund in the amount of $473.88 for overpayment of income taxes for the calendar year 1930. The said claim was predicated on the basis that, of the dis-

tribution of $21,750 received by her from the Foster Lumber Company during 1930 and reported in its entirety, the amount of $13,802.33 was paid out of surplus accumulated or appreciation of land and timber arising before March 1, 1913, and was to that extent and for that reason exempt from tax. The Commissioner of Internal Revenue disallowed the contention raised in the claim and instead determined the deficiency of $363.93 by disallowing a loss claimed on the return of $4,695.38.

The sole question to be determined in this proceeding, is the extent to which the distribution received in 1930 is taxable.

The Foster Lumber Company was organized under the laws of the State of Missouri during 1896 and was at all times herein mentioned and now is a Missouri corporation. At all times subsequent to its organization and prior to October 10, 1929, said company was authorized to issue and had issued as its only capital stock 2,000 shares of common stock having a par value of $100 per share.

The purposes for which the Foster Lumber Company was formed are the manufacturing, buying and selling of lumber, buying and selling of grain, coal, glass, paints, oils, lime, hair, brick and all other kinds of building material, whether they be of the same class or kind of any of those above, especially mentioned or described or not; the buying and selling of general merchandise, and the buying, selling, and leasing of lands, when the same may be necessary in the conduct of its said business.

On March 1, 1913, the earnings or profits accumulated and increase in value of property accrued prior to that date of the Foster Lumber Company were in excess of $3,725,000.

The following tabulation sets forth with reference to the Foster Lumber Company, in column "A" the period involved, in column "B" the amount of the earnings, or profits for that period, in column "C" the amount of distribution on the last day of the indicated period and in column "D" the balance of the earnings, or profits accumulated subsequent to February 28, 1913:

(Tabulation not quoted.)

The capital stock of the Foster Lumber Company has always been owned by members of the Foster family. Three members of the family who had removed to California were stockholders in the corporation and in order that they might retire from ownership of and participation in the affairs of the corporation and also that a rearrangement of interests might be effected it was decided to retire and cancel 500 shares of the company's capital stock. Accordingly, under date of July 20, 1929, the Foster Lumber Company by formal written notice to all of its stockholders requested that each of them notify it if they were in favor of a reduction in the capital stock of the company from $200,000 to $150,000 by the acquisition and cancellation by the company of $500 shares of its outstanding capital stock of 2,000 shares from the therein named stockholders in the proportions and for the amounts set forth in that letter.

Under date of September 18, 1929, the Foster Lumber Company by formal written notice to all of its stockholders advised them that since they had indicated their desire to decrease the capital stock of the company from $200,000 to $150,000, as per letter of July 20, 1929, it was necessary, under the statutes of the State of Missouri, to hold a special meeting of the company's stockholders, at which all of the said stock must be represented either in person or by proxy, and to pass a unanimous resolution for the decrease in capital stock as set forth in its notice to stockholders dated July 20, 1929. They and each of them were also requested to execute a waiver of publication and mailing of notice and consent to the said reduction in the capital stock at said special meeting of stockholders.

Each and everyone of the stockholders executed a waiver of publication and mailing of notice and consent to the reduction in capital stock as requested by the Foster Lumber Company and mailed the same to the said corporation.

At a special meeting of the stockholders of the Foster Lumber Company held October 1, 1929, at the office of that company at which all of the stockholders of said company were present in person, or were represented by proxy, the

following resolution was adopted by the unanimous vote of all the stockholders:

Upon motion, duly made and seconded, it was resolved that:

WHEREAS, the capital stock of the company is for the sum of Two Hundred Thousand Dollars, divided into two thousand shares, of the par value of One Hundred Dollars each, and,

WHEREAS, the Company has no outstanding unpaid obligations except the comparatively small amount of current accounts payable, and

WHEREAS, there are ample funds in the treasury of the Company to do so:

BE IT RESOLVED: That the capital stock of the Company be decreased from said Two Hundred Thousand Dollars, divided into Two Thousand Shares of the par value of One Hundred Dollars, to the sum of One Hundred and Fifty Thousand Dollars, divided into Fifteen Hundred shares of the par value of One Hundred Dollars each.

The Foster Lumber Company having theretofore in all respects complied with the laws of the State of Missouri made and provided for the decrease of capital stock, the Secretary of State for the State of Missouri on October 8, 1929, certified to the decrease in the capital stock of that corporation to the amount of $150,000.

On October 10, 1929, the Foster Lumber Company distributed $1,025,000 in cash to its stockholders for 500 shares of its capital stock retired on that date pursuant to the resolutions adopted at the special meeting of its stockholders held October 1, 1929, and as set out above. On the books of the corporation, $975,000 of the amount distributed was charged to surplus and $50,000 to the capital stock account. The stock retired was immediately cancelled.

The distribution of October 10, 1929, was on the basis of $2,050 per share. For the purpose of determining the taxable income for 1929, all the stockholders whose stock was retired, contended for a March 1, 1913, value of $2,090.75 per share, or a loss of $40.75 per share. The tax liability was finally settled by agreement with the several

stockholders upon a valuation at March 1, 1913, of $2,050 per share. There was no taxable income to the stockholders determined as arising out of the retirement of the stock in 1929.

The authorized and issued capital stock of the Foster Lumber Company from and after the distribution of October 10, 1929, continuously to the present time has been in the amount of $150,000 represented by 1,500 shares of a par value of $100 per share.

The applicable statute and the regulations promulgated thereunder are set out in the margin. As we read the statute, the distribution of October 10, 1929 must be marshalled first against the capital to the extent of the par value of the 500 shares of stock redeemed and retired, then against the earnings after February 28, 1913 which were on hand October 10, 1929. It more than exhausted these sources and what was left was paid from capital or earnings accumulated prior to March 1, 1913. It follows therefore that the dividend distribution of February 11, 1930, in the amount of $225,000 should be marshalled first against the earnings or profits accumulated subsequent to October 10, 1929 and on hand February 11, 1930 ($82,758.17) and then against the capital increment or earnings or profits accumulated prior to March 1, 1913 ($142,241.83). The former is subject to a surtax in the hands of the stockholder distributee. The latter is exempt.

Petitioner's decedent received from the dividend of February 11, 1930, $21,750. Of this amount 82,758.17/225,000 is subject to surtax and the balance is exempt. *John E. Stewart et al.*, 29 B. T. A. 809; *Harter* v. *Helvering*, 79 Fed. (2) 12.

Since petitioner's decedent included the entire dividend of $21,750 in her return and there will result an overpayment of her tax.

The decision will be entered under Rule 50.

Entered: Mar. 15, 1937.